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## BOARD ADOPTED POLICIES

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**POLICY NUMBER:** 2.11.100

**EFFECTIVE DATE:** 7/1/03

**TITLE:** Defined Contribution Plan 3  
Retirement Funds

**SUPERSEDES:** 7/1/02

**BOARD ADOPTION:** 6/20/02

**APPROVED:** *Joseph A. DeCar*

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### BACKGROUND:

Revised Code of Washington (RCW) 41.34.120 states that the assets of the Teachers' Retirement System Plan 3 (TRS 3), School Employees' Retirement System Plan 3 (SERS 3), and Public Employees' Retirement System Plan 3 (PERS 3) are held in trust for the exclusive benefit of the participants and names the Washington State Investment Board (WSIB) as trustee of the assets. In accordance with RCW 41.34.130 and 43.33A.190, the WSIB has the sole authority over selection and management of the investment options. The Employee Retirement Benefits Board (ERBB) makes recommendations to the WSIB on types of self-directed options, reflecting the members' preferences. In accordance with RCW 41.34.130, the WSIB, after consultation with the ERBB on such recommendations, determines the investment options for the programs. The Department of Retirement Systems (DRS) has responsibility for program administration, investment accounting, and participant record keeping, education, and communication.

TRS 3, SERS 3, and PERS 3 are hybrid pension plans comprised of a defined benefit and a defined contribution plan. The employer contribution funds a 1 percent formula defined benefit. The employee contribution is invested in a defined contribution 401(a) program. The employee sets the contribution rate from a menu of options and directs the investment of the funds. Within the investment options, the employee may invest their contributions into the Commingled Trust Fund (CTF) through the Total Allocation Portfolio (TAP). The employee contribution is a self-directed retirement account; therefore, the employee's proper selection of options, or asset allocation, is critical for sufficient growth of the funds and for meeting the employee's desired retirement goals.

Since TRS 3, SERS 3, and PERS 3 are similar in structure and identical in purpose and intent, the standard of care, investment objective, risk constraints, investment structure, and investment options for each are identical. Therefore, all plans are combined into this single investment policy (Defined Contribution Plan 3 Retirement Funds).

## **PURPOSE:**

This document outlines the investment policy for the assets of the programs. It is designed to articulate the WSIB's investment objectives and risk tolerance for the investment options in accordance with RCW 43.33A.110, 43.33A.140, 43.33A.190, 41.34.060, and 41.34.130. This document also formulates the Board's policies and guidelines on: (1) the number and type of options; (2) the investment style and strategy for each specific investment option; and (3) the process of prudently monitoring and evaluating the performance and risk of the investment options.

## **POLICY:**

### **Standard of Care**

Under RCW 41.34.120 and 43.33A.030, trusteeship of all defined contribution funds is vested in the voting members of the Board. The Legislature has established a standard of care for investment of these funds in RCW 43.33A.140. Additionally, the Board and its staff must comply with other state laws, such as the Ethics In Public Service Act, Chapter 42.52 RCW, as it makes investment decisions and seeks to meet the investment objectives listed below.

### **Investment Objectives**

In accordance with RCW 43.33A.110, the investment objective of all assets under the control of the WSIB, which include the assets in these programs, is to seek the maximum return at a prudent level of risk. The WSIB has a fiduciary duty to ensure that each plan's self-directed program offers a balance of options to allow employees to build an asset allocation suitable for a range of participants from new employees to those in retirement. The investment options cover a broad spectrum of funds from low risk/low return to high risk/high return. The majority of the options offer participants the opportunity to seek long-term capital appreciation.

Based on this requirement the order of the objectives are:

1. Provide a diverse set of investment options to allow participants to invest their funds to maximize their future capital accumulation for retirement at their personal level of risk tolerance.
2. Provide an adequate number of options. The number of options should be broad enough to offer a comprehensive set of options, yet be limited in number to make the programs easy to understand and offer the participant the ease of creating a diversified portfolio.
3. Minimize expenses to the participants.
4. Ensure that each investment option maintains its investment objectives and investment strategy as described to participants.

5. Provide investment options that do not compromise the participant's confidence in the programs.

In keeping with these objectives and to offer an efficient and cost-effective investment menu, it must be understood that not every participant's unique desire or request can be met. Participants' requests for specialized funds or highly focused investment strategies are best obtained through their own personal investments. This list of options is designed to provide the best menu of investment options for a broad group of participants and cannot be all things to each individual person.

### **Risk Constraint Standards**

1. Invest the assets to maximize return at a prudent level of risk in accordance with the requirements of RCW 43.33A.110 and RCW 43.33A.140. Within each plan, the WSIB offers investment options that are suitable for long-term retirement investments for individuals.
2. Ensure that the stable value/money market option is invested in a manner to facilitate the maintenance of a one-dollar net asset value.
3. Ensure that each investment option is within its prescribed level of risk.

### **Investment Performance Objectives**

Since each participant in the employee portion of the plan is responsible for the design and selection of their investment portfolio, the overall program does not have an aggregate investment performance objective. However, each investment option described below has a specific investment performance objective.

### **Asset Allocation and Investment Options**

The WSIB offers the investment options listed below for each plan. The WSIB will adjust the investment management of the options as deemed necessary.

Capital market conditions, management style of investment options, and investment performance are dynamic, not static. Consequently, the WSIB staff reviews the performance and management of the options with the ERBB quarterly. For those options managed internally by the WSIB, the Board has delegated to the executive director the authority to invest the funds according to the procedures established by the executive director pursuant to written policies and procedures.

Within the limit on the number of options, the WSIB strives to offer a comprehensive array of options including balanced life-cycle funds.

### **Investment Options**

<b><u>Asset Class</u></b>	<b><u>Style</u></b>	<b><u>Fund</u></b>
Money Market	Short-term investment	Money Market Fund
Fixed Income	Active intermediate bond	Bond Fund
Balanced	Balanced equity/debt	Total Allocation Portfolio  Socially Responsible Balanced Fund  Washington State Horizon Funds: - Long-Horizon Fund - Mid-Horizon Fund - Short-Horizon Fund
U.S. Equities	Passive broad market index  Passive large-cap index  Passive small-cap index	U.S. Stock Market Index Fund  U.S. Large Stock Index Fund  U.S. Small Stock Index Fund
International Equity	Passive international index	International Stock Index Fund

### **Investment Options, Objective, and Style**

#### **Money Market Fund**

*Objective:* The money market option seeks to protect principal while generating an income return in excess of inflation. The fund is expected to maintain a one-dollar net asset value.

*Strategy:* The fund invests in high quality short-term securities.

*Benchmark:* One-month LIBOR

#### **Bond Fund**

*Objective:* The fund seeks a high level of current income. The fund is expected to meet or exceed the return of the Lehman Intermediate Credit Index.

*Strategy:* The fund invests in investment grade rated U.S. and dollar denominated international fixed income instruments. The average portfolio maturity ranges between three to ten years.

*Benchmark:* Lehman Intermediate Credit Index

### **Total Allocation Portfolio (TAP)**

*Objective:* A balanced fund that seeks to achieve a maximum long-term rate of return at a prudent level of risk. The fund's long-term objective is to exceed the median return of other public pension plans that represent the fund's peer group.

*Strategy:* The TAP Fund is invested into the WSIB CTF, which is comprised of the assets of multiple public employee retirement funds managed by the WSIB. It has an aggressive asset allocation that includes U.S. equity, international equity, actively managed fixed income, U.S. and international private equity and real estate, and short-term instruments. The portfolio includes private securities that are not actively priced on a regular basis; therefore, the credited return is an approximation of the overall portfolio return. The fund value is calculated monthly.

*Benchmark:* Custom blend matched to the Retirement CTF Asset Allocation Policy approved by the Board.

### **Socially Responsible Balanced Fund**

*Objective:* A balanced fund that seeks long-term capital growth through an actively managed portfolio of stocks, bonds, and money market instruments consistent with certain social criteria established by the fund. The fund's one-year return should exceed the median return of a balanced fund peer group.

*Strategy:* The fund seeks to invest in a portfolio of companies that have demonstrated above average performance in a variety of social criteria. All holdings pass a broadly defined set of social screens, such as product safety and desirability, workplace issues, environmental impacts, international operations, and weapons contracting.

*Benchmark:* Custom blend – 55 percent S&P 500 Index and 45 percent Lehman Aggregate Index.

### **Washington State Horizon Funds**

#### **Long Horizon**

*Objective:* A balanced fund managed for participants with a long investment horizon. The fund seeks to achieve a maximum long-term rate of return and accepts large fluctuations in the year-to-year returns. The fund has a target asset allocation that places the majority of the assets in U.S. and international equities, with the remainder in U.S. fixed income.

*Strategy:* The fund invests passively in the broad indices that track the U.S. and the international equity markets plus an actively managed intermediate duration bond fund. The asset allocation is actively rebalanced to maintain the target mix.

*Benchmark:* Custom blend matched to the target allocation using the component benchmarks approved by the Board.

### **Mid Horizon**

*Objective:* A balanced fund managed for participants with a medium-term investment horizon. The fund seeks to achieve a maximum rate of return and accepts fluctuations in the year-to-year returns. The fund has a target asset allocation that places slightly more than half of the assets in U.S. and international equities with the remainder invested in U.S. fixed income.

*Strategy:* The fund invests passively in the broad indices that track the U.S. and the international equity markets plus an actively managed intermediate duration bond fund. The asset allocation is actively rebalanced to maintain the target mix.

*Benchmark:* Custom blend matched to the target allocation using the component benchmarks approved by the Board.

### **Short Horizon**

*Objective:* A balanced fund managed for participants with a short-term investment horizon. The fund seeks a more conservative rate of return but with some fluctuations in the volatility of the year-to-year returns. The fund has a target asset allocation that places a majority of the assets in lower risk and return bonds and in cash investments while still investing some of the assets in U.S. and international equities.

*Strategy:* The fund invests passively in the broad indices that track the U.S. and the international equity markets plus an actively managed intermediate duration bond fund and short-term cash investments. The asset allocation is actively rebalanced to maintain the target mix.

*Benchmark:* Custom blend matched to the target allocation using the component benchmarks approved by the Board.

### **U.S. Stock Market Index Fund**

*Objective:* Passively managed to approximate the return of the Russell 3000 Index within a tracking error of 30 basis points annually.

*Strategy:* The fund invests in U.S. equities, futures, and options in order to approximate the characteristics and performance of the broad U.S. stock market.

*Benchmark:* Russell 3000 Index

### **U.S. Large Stock Index Fund**

*Objective:* Passively managed to approximate the return of the Standard & Poor's 500 Index within a tracking error of 5 basis points annually.

*Strategy:* The fund invests primarily in U.S. equities, futures, and options in order to approximate the characteristics and performance of the S&P 500 Index.

*Benchmark:* S&P 500 Index

### **U.S. Small Stock Index Fund**

*Objective:* Passively managed to approximate the return of the Russell 2000 index.

*Strategy:* To approximate the characteristics and performance of the small-capitalization sector of the U.S. equity market.

*Benchmark:* Russell 2000 Index

### **International Stock Index Fund**

*Objective:* Passively managed to approximate the return of the international equities market as tracked by the Morgan Stanley Capital International Europe, Australia, Far East Index (MSCI EAFE) within a tracking error of 20 basis points annually.

*Strategy:* The fund invests in international and some U.S. equities, futures, and options in order to approximate the characteristics and performance of the MSCI EAFE Index.

*Benchmark:* MSCI EAFE Index

### **PERFORMANCE REVIEW GUIDELINES AND REPORTING:**

Performance of the TAP Fund, the Horizon Funds, and the Bond Market Fund is reported by the WSIB staff. Since the WSIB does not perform investment fund accounting for these programs, the specific investment manager measures investment performance of the external options. The WSIB investment staff compiles and performs a quality check of the returns from the investment managers and reports quarterly to the Board and ERBB for each plan. The quarterly report identifies the distribution of the participant's assets among the various options for each plan and compares each option to its appropriate benchmark.

**POLICY (IMPLEMENTATION):**

The Board has established numerous policies and procedures for the investment staff to ensure consistent and efficient handling of the investment duties. The Board regularly reviews performance and costs of all funds under its control. On an annual basis, the Board reviews all the investment costs of the WSIB, including investment management and external service providers. Any direct costs related to the management of fund assets will be deducted from the return of the various investment options. Additionally, under RCW 43.33A.160, the WSIB is allowed to deduct from the funds under its control the fund's proportional share of the WSIB's operating expenses, based on its assets under management.

**RESPONSIBILITIES:**

Washington State Investment Board - Responsible for approving the investment policy, setting the investment options, and reviewing the investment performance of the options.

Public Markets Committee - Responsible for reviewing and recommending the investment policy and investment options to the Board. Also responsible for reviewing the WSIB staff's investment management guidelines.

WSIB Staff - Responsible for direct management and daily pricing/unitization of the internally managed investment options; oversight, monitoring, and evaluating the external investment managers; and preparing and presenting the quarterly investment report. Additionally, responsible for recommending enhancements and changes to the investment policy and investment options to the Public Markets Committee and implementing the policy changes, managing the assets, and reporting performance and compliance to the policy (custody account management) to the Public Markets Committee, the ERBB, and the Board.

Employee Retirement Benefits Board – Responsible for consulting with the WSIB regarding recommendations for options for participants to choose for investment of the deferred portion of their income (RCW 41.34.130).

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